LORICA | INVESTMENT COUNSEL INC.

Focused Fixed Income

Market Highlights

Bond markets were once again fixated on the Fed and Janet Yellen and Co. did not disappoint. There were no fewer than 9 speeches by FOMC members during the month with a definite tone of hawkishness – or as close to hawkishness as hints of one ¼ point increase in December followed by a much-advertised *go-slow* approach permits. The bond market, which had been pricing in a 23% probability of a ¼ point increase prior to the September meeting, was pricing in a 70% probability at the end of November according to Fed Fund futures.

The US yield curve flattened during the month with 2-year yields rising by 26 basis points compared to 10-year and long yields which rose 7 and 6 basis points respectively. In Canada, the yield curve move was more muted with 2 and 10-year yields rising by 5 and 2 basis points respectively, and long yields falling by 2 basis points.

Investors appear to be getting more comfortable with a Fed increase, and though the data had already been supportive of moving off zero in September, the Fed was neither convinced nor convincing at that time. Great effort has now gone into preparing the market for a hike, and equity markets, while off for the month – S&P 500 was flat at up 0.3%, 3% for the year – have been relatively well behaved.

The rise in longer term Canadian and US yields has, been somewhat offset by the effects of the recent decline in European yields, which has once again, encouraged investors to look elsewhere to pickup yield. Investors had interpreted signals from Mario Draghi as suggesting that the ECB would not just continue the QE program, but would also likely increase the size of the program - Bund yields fell during November by as much as 12 basis points in 2-years, and 6 basis points in 10-years. Investors inferred from Draghi's comments following the ECB's December meeting that the program would not grow, causing European yields to back-up.

The corporate market was relatively quiet during November as new issuance underwhelmed and secondary trading was muted. Some demand did emerge from the December 1st coupon payment, which resulted in an extension of the Universe Index duration by 0.1 years, moving the overall duration to 7.4 years. Yield spreads did manage to move in with the demand, an overall average of 2 basis points, but with short spreads unchanged and mid and long spreads narrowed by 4 and 3 basis points respectively.

Provincials and agencies (primarily CMB's) were the worst performing sectors during November, with mid-term spreads moving out 5 basis points for both. Foreign selling of provincials, which had abated after the late summer surge, seemed to reappear and drive spreads a wider, with agencies widening in sympathy.

Outlook & Strategy

We think the next several quarters will be all about the Fed and its attempt to get off zero. We expect the Fed to move by 25 basis points in December. At this point, we feel the most likely thing that could come between the Fed and its game plan is an unexpected disruption to riskier markets, primarily equities. The Fed has pulled away from tightening due to capital market instability before, although never with this amount of telegraph and pricing embedded in the market

In the event that the Fed raises rates, the US yield curve should rise, albeit with a slight flattening bias. The Canadian yield curve will steepen, as short term yields reflect the Bank of Canada's negative outlook, while longer-term yields track, but lag, Treasuries. Risk assets may also be more volatile, although we maintain that fundamentals are still supportive, which should keep short term spreads within their break-evens.

In the event the Fed were to remain on hold, we would expect significant volatility, but with an ultimate move down in longer term yields as investors conclude that the economy's fundamentals are "worse than previously thought". It would also likely induce another round of "risk-on" behavior.

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